Background Information - The
Canadian Automotive Industry

BACKGROUND INFORMATION
THE CANADIAN AUTOMOTIVE INDUSTRY

Introduction

The Canadian automotive industry is generally efficient, profitable, and price competitive, and has enjoyed substantial growth during the last ten years. The industry in Canada is constituted as follows:

- the major vehicle manufacturers (General Motors, Ford, Chrysler, American Motors) and several truck manufacturing firms. These companies also make about one third of the original-equipment parts produced in Canada. The parts (major components such as engines and transmissions) are made in "captive" (same company) plants.

- the independent parts manufacturers, which include a number of large multinational firms and an additional 470 firms, many of which are Canadian-owned.

The industry is largely located in southern Ontario.

The Automotive Products Trade Agreement of 1965

A major factor contributing to the overall health of the Canadian industry has been the Automotive Agreement of 1965. The Agreement provides for conditional duty-free trade between Canada and the U.S. in original-equipment parts and in all but certain specialized types of newly manufactured vehicles.

It excludes trade in aftermarket (replacement) parts and accessories, tires and tubes, batteries and used vehicles.

Under the Agreement, duty-free entry of vehicles and parts is subject to specific "safeguard" conditions. These safeguards were, among other things, responsive to the specific interests of the labour unions and the independent parts producers.

Largely as a result of the Agreement, the Canadian industry has developed from one characterized by the production of a low volume of a large number of different products mainly for the Canadian market to the assembly of fewer car models and production of a smaller range of parts in larger volumes for an integrated North American market. About 70 per cent of Canadian vehicle production and 80 per cent of our independent parts production are now exported to the U.S.

The Automotive Agreement led initially to substantial new investment in Canada by the major vehicle manufacturers. Much of this investment went into vehicle assembly and to a much lesser extent into parts production. This can be attributed in part to the implementation by the motor vehicle manufacturers of certain requirements of the Agreement and to Canada's historical cost advantage in a relatively labour-intensive sector of the industry. This concentration of investment in vehicle assembly resulted in a large amount of employment in Canada, but of a less-skilled type. In the period since 1965, Canada's overall trade balance in the automotive area has fluctuated largely

in response to overall economic conditions in the United States and Canada. The trend under the Agreement has been toward a trade surplus for Canada in vehicles and a deficit in original-equipment parts. Most of the Canadian parts deficit can, however, be attributed to trade in "captive" parts rather than to trade by independent parts producers. The latter is roughly in balance.

A significant part of the Canadian automotive industry that is not governed by the terms of the Automotive Agreement is the aftermarket parts industry. This industry is comprised of some 375 firms, many of which also produce original-equipment parts. Notwithstanding a relatively high average tariff of 15%, a large number of aftermarket parts are imported into Canada. Exports to the U.S. are impeded more by marketing and distribution problems than by the relatively low U.S. tariffs, averaging 4 per cent.

The Automotive Agreement has tended to re-inforce an historic pattern vis-à-vis the limited autonomy of USA subsidiaries in Canada and the location of corporate functions. Management functions such as R&D and engineering have become increasingly located in head offices in the U.S., while the principal efforts of subsidiaries in Canada are devoted to production. For example, R&D expenditures by the Big Three in the U.S. amounted to approximately $3 billion in 1977. An additional $245 million was spent in the U.S. by the 21 leading parts suppliers. In comparison, total automotive R&D expenditure in Canada in the same year amounted to about $8 million.

The Automotive Agreement has not significantly altered the regional distribution of the industry in Canada. In 1964, Ontario produced 98 per cent of vehicles and parts. Today Ontario accounts for 89 per cent of vehicle and 98 per cent of parts production in the country.

Performance of the Canadian Automotive Industry

1. Employment and Productivity

Total employment in the industry in Canada was about 70,000 in 1964. It grew to 117,000 in 1977 with 63,000 in vehicle assembly and truck body and trailer production and 54,000 in automotive parts and accessories and fabrics. This rate of growth was about 30% higher than the rate of growth in employment in the Canadian economy at large.

Between 1967 and 1976, in the Canadian parts industry, the "value-added" per employee in parts production (including the aftermarket) increased from 77 per cent of the U.S. level to 93.5 per cent. In vehicle assembly, Canadian productivity now exceeds the U.S. level by about 20 per cent on the basis of motor vehicles per man-hour.

2. Profitability and Investment

Major Motor Vehicle Manufacturers

From 1970 to 1975, the profit margins of the major motor vehicle manufacturers in Canada were above those of their U.S. parent companies. This profit premium has declined in recent years because of the impact of the anti-inflation program, competition and the decline in the exchange-adjusted differential in auto prices. Between 1965 and 1977, the Big Four vehicle manufacturers made net direct investments in new plant and equipment in Canada that were on average about only 6.5 per cent of those made in the U.S.A. ($1.3 billion as against $20 billion). All the Canadian vehicle manufacturers' investment was financed by retained earnings from Canadian operations.

Parts Producers

A survey of some 145 U.S. firms and 200 Canadian parts-making firms, including both "captive" and independent producers, indicates that average Canadian industry profits have been above the mean in the U.S. in every year from 1967 to 1975. Moreover, a Canada-U.S. comparison of major independent parts makers indicates a significantly higher after-tax profit in Canadian operations, averaging 17.8 per cent as compared to 12.6 per cent in the U.S. between 1973 and 1977.

New investment in plant and equipment by the major independent parts producers in Canada has been lower than in the U.S., averaging 35 per cent of combined after-tax profits, depreciation and deferred taxes in Canada as compared to 59 per cent in the U.S. between 1973 and 1977.

In summary, the trend has been for Canadian parts-makers, while earning higher profits than their American counterparts, to invest proportionately less. At the same time, the level of investment of Canadian parts-makers (as a percentage of North America investment) is higher than that of the major motor-vehicle manufacturers in Canada.

3. Production

Canadian "value-added" as a proportion of total North American production is another measure of industry performance. Canadian "value-added" averaged about 4 per cent of total North American production in the early years of the Agreement. In the last four years, it has averaged about 6 per cent of North American production. This compares to Canadian consumption which is about 8 to 9 per cent of the North American market. Parts production contributed about two thirds of the total "value-added" of $4 billion in 1977 for the industry in Canada. The other third was from vehicle assembly.

4. Trade

Trade in Goods Under the Automotive Agreement

Between 1966 and 1977, total trade in and out of Canada in goods under the Automotive Agreement was $113 billion. Canada had a cumulative deficit over this period of less than 2%. Annual trade balances under the Agreement have, however, fluctuated significantly over the period, depending on the timing

of investment and variations in demand in Canada and the U.S. In the mid-to-late-sixties, a surge of automotive investment in Canada moved Canada from annual deficits to surpluses between 1969 and 1972. Canada returned to a position of annual deficits in the mid-seventies because of a relative lack of new investment by industry and because of a severe recession in the U.S. while the Canadian market remained relatively buoyant. Since 1975, the annual Canadian deficit has declined significantly, largely as a result of a resurgence in U.S. demand.

The above commodity statistics do not cover non-merchandise items. The latter include payments to U.S. head offices for R&D work, tooling, engineering and management fees. It was estimated to be a deficit of $448 million during 1977 by Statistics Canada, but could be higher.

Trade Outside the Agreement

Between 1966 and 1977, the total value of vehicles and parts going in and out of Canada unrelated to the Automotive Agreement was $13 billion. Canada's deficit in the trade for the period was about $7 2/3 billion: a deficit of $3 1/3 billion with the U.S., primarily in aftermarket parts, and a deficit of $4 1/3 billion with "third" countries in both vehicles and parts.

Industry Issues and Prospects

1. Technological Change and Investment

The major challenge affecting the future of the industry in North America

is the technological change that will be required to meet higher fuel prices with more fuel-efficient vehicles and government-mandated emission and safety standards. These standards will require the development of new automotive technologies and will double the normal rate of capital investment.

If the Canadian industry is to be in a position to address this challenge and exploit new opportunities and thus ensure its future viability, substantial new investments in capital and technology will be required. It can be expected that vehicle manufacturers will make some investment in Canada to meet their obligations under the Automotive Agreement. Concern has been expressed, however, that the smaller, generally Canadian-owned parts manufacturers will not be able to make the investments or develop or obtain the new technologies required. Although the Canadian subsidiaries of multinational parts manufacturers should continue to be able to obtain new technology from their parents, concern has been expressed that they participate fully in new investment to be made.

This situation is aggravated by U.S. federal, state and local programs of investment incentives, which will tend to encourage vehicle and part producers, both Canadian and U.S. owned, to retain new investment in the U.S. This may be particularly true for the independent parts producers, who have no obligations under the Automotive Agreement.

Nevertheless, assuming that some solutions can be found to the investment incentive issue, the Canadian automotive investment climate appears to be

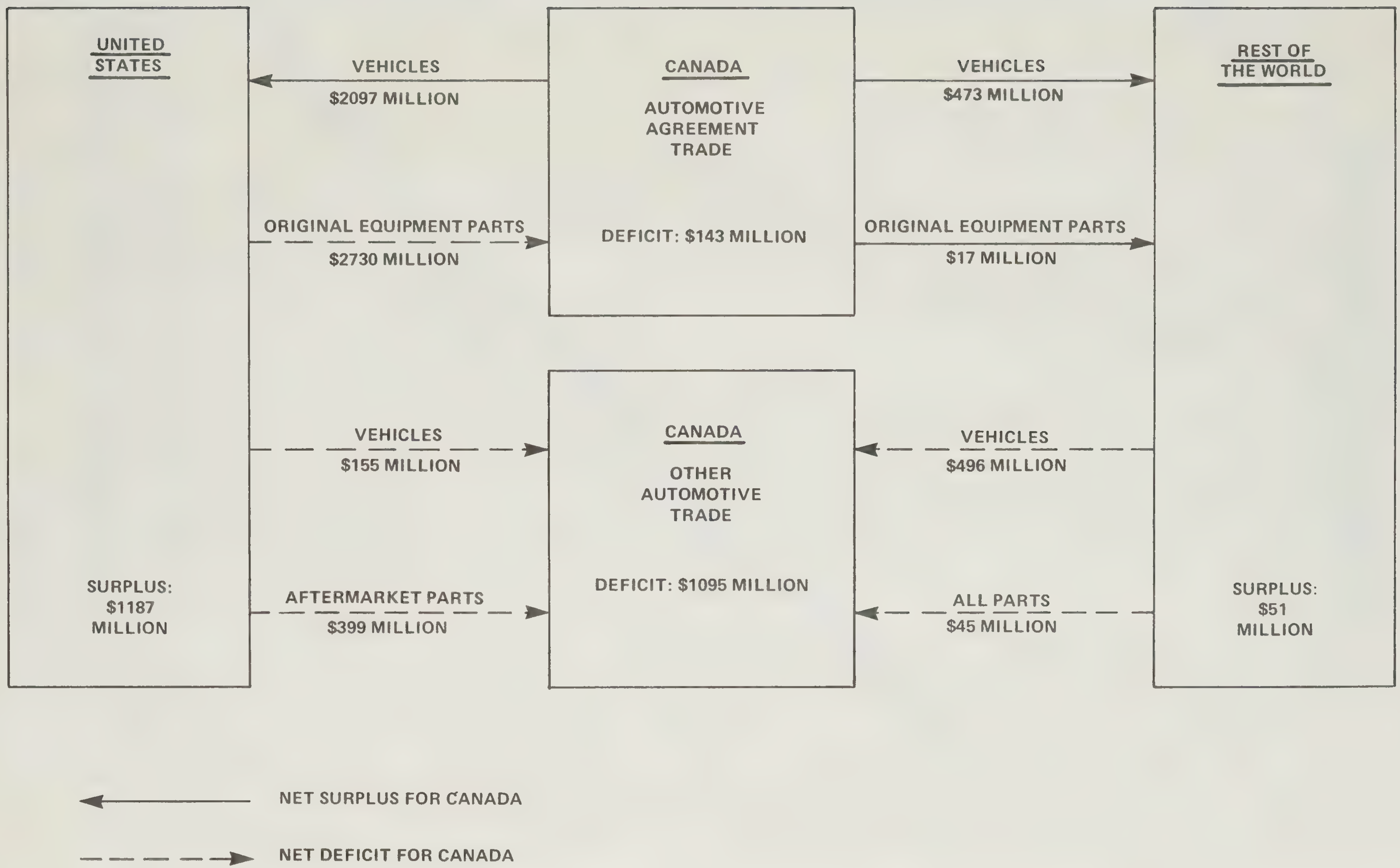
sufficiently attractive to ensure a reasonable participation in new investment: Canadian labour and other costs are increasing at a slower pace than those in the U.S., the Canadian corporate tax environment is favourable and Canadian industry is competitive under current exchange rates. These factors suggest that the traditionally higher rate of return in the Canadian automotive industry can be maintained.

2. Longer-Term Structural Issues

Non-merchandise transactions such as R&D payments, management fees and dividends are a major contributor to Canada's overall automotive deficit. This virtually one-way trade in "invisibles" reflects the structure of the industry, mainly made up of large multinational companies that have centralized management and R&D functions in U.S. headquarters. Although recently increased government direct assistance and tax incentives for R&D will have a beneficial impact on automotive development in Canada, particularly on the smaller, more autonomous multinationals, only a more fundamental modification of the structure and organization of the North American automotive industry will produce a Canadian industry with a greater degree of technological and managerial independence.

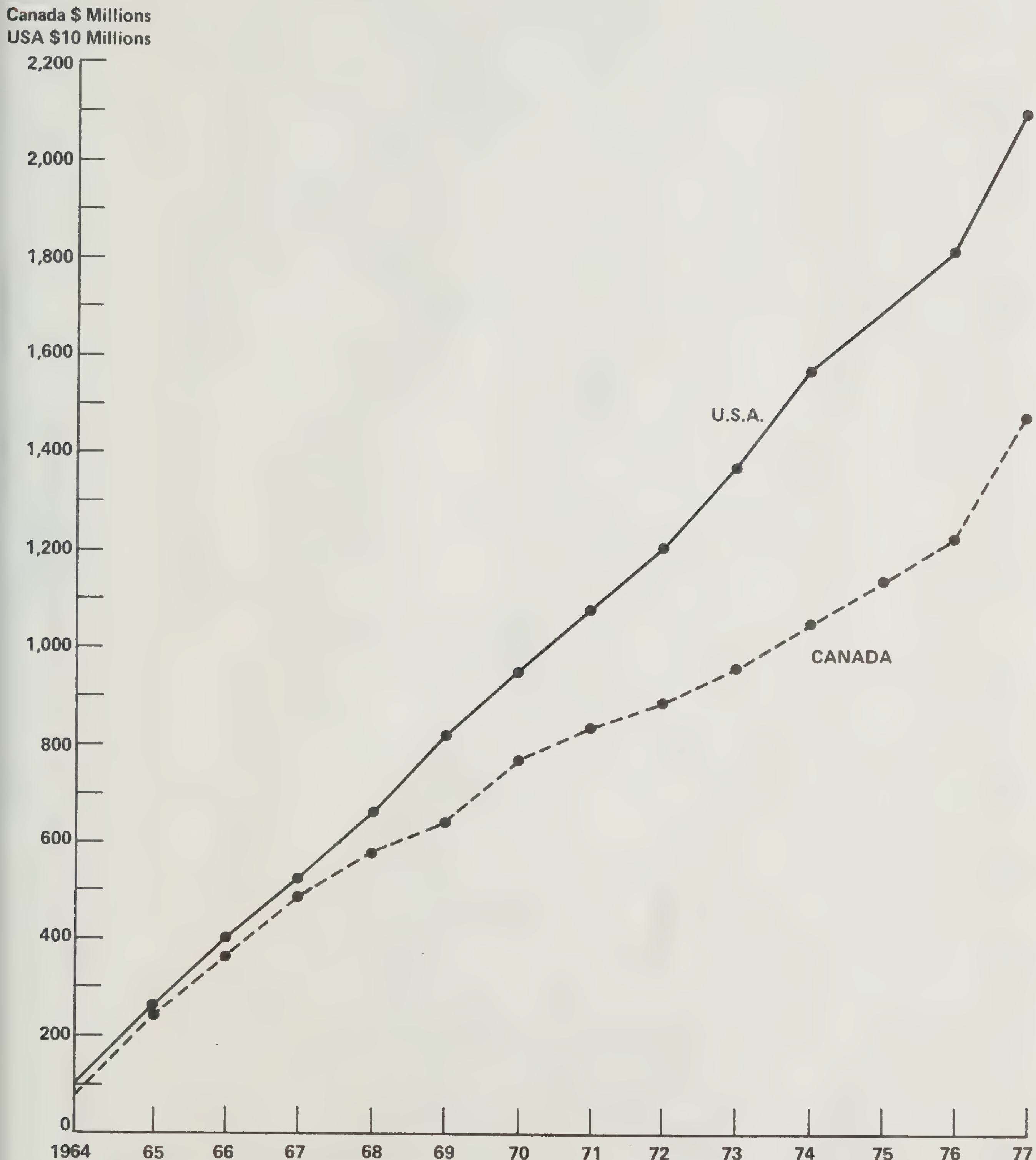
CANADA'S WORLD-WIDE AUTOMOTIVE TRADE IN 1977

NET COMMODITY TRADE FLOWS



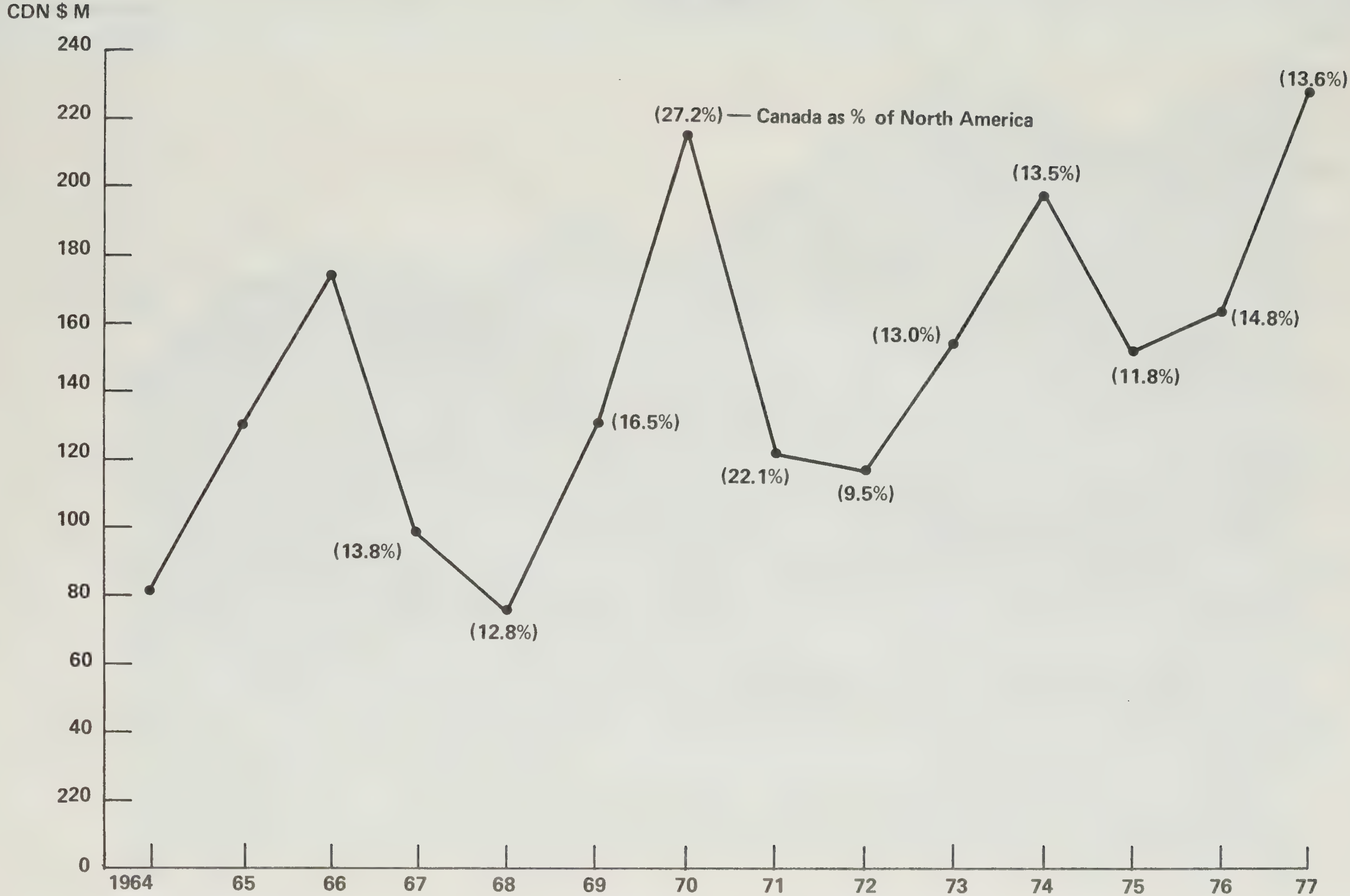
SOURCE: STATISTICS CANADA

CHART 2
NET DIRECT INVESTMENT EXPENDITURES (CUMULATIVE)
ON PLANT AND EQUIPMENT FOR THE PRODUCTION OF
MOTOR VEHICLE PRODUCTS RELATED TO THE AUTOMOTIVE AGREEMENT
1964-1977



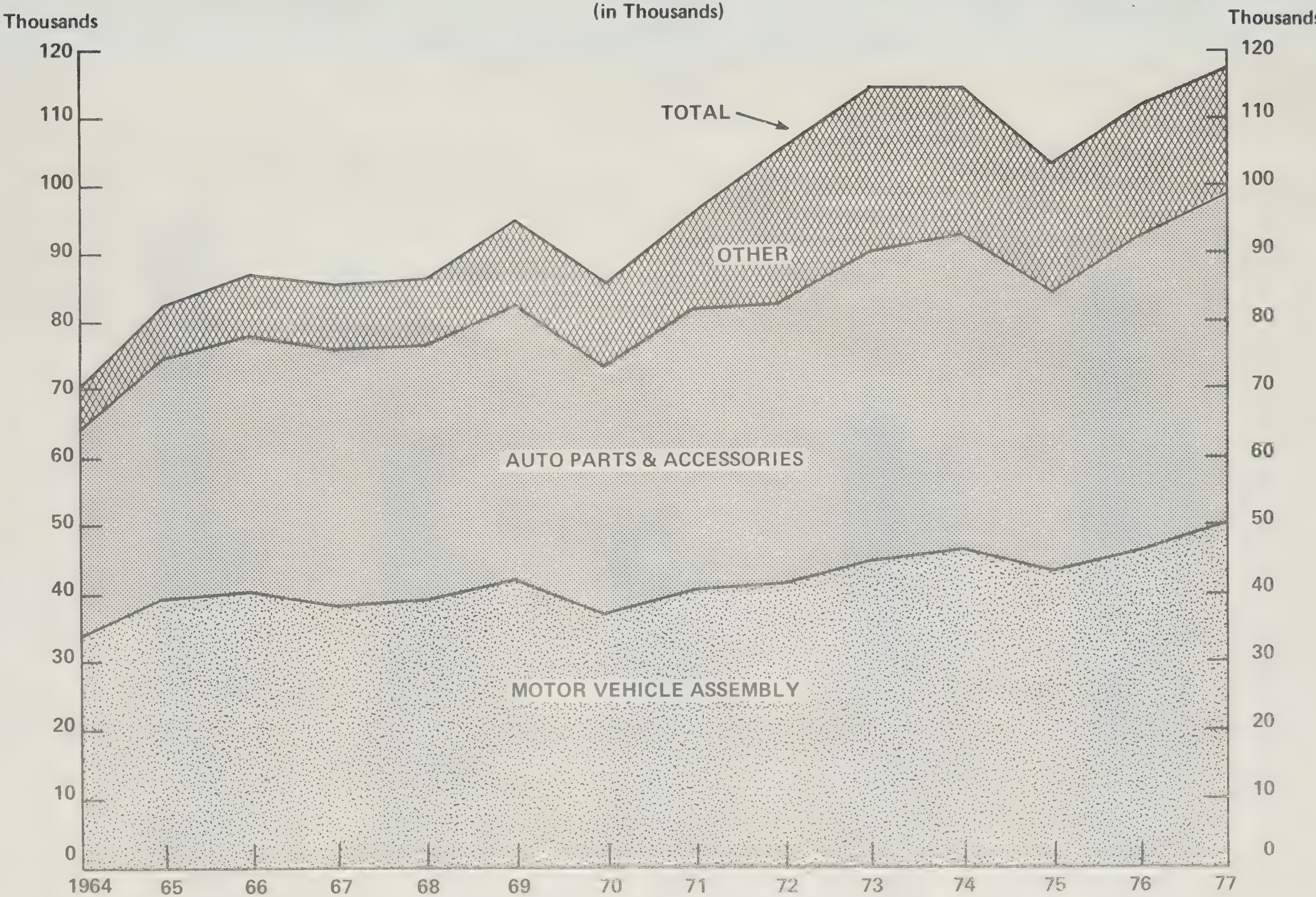
Source: Compiled from firms' responses to questionnaires of the Reisman Commission

AND ACCESSORIES MANUFACTURERS IN CANADA
1964-1977
(in Canadian $ Millions)



Source: Statistics Canada (data relate to SIC 325).
U.S. Bureau of Census, Annual Survey of Manufacture (data relate to SIC 3714), in Reisman, p. 100.

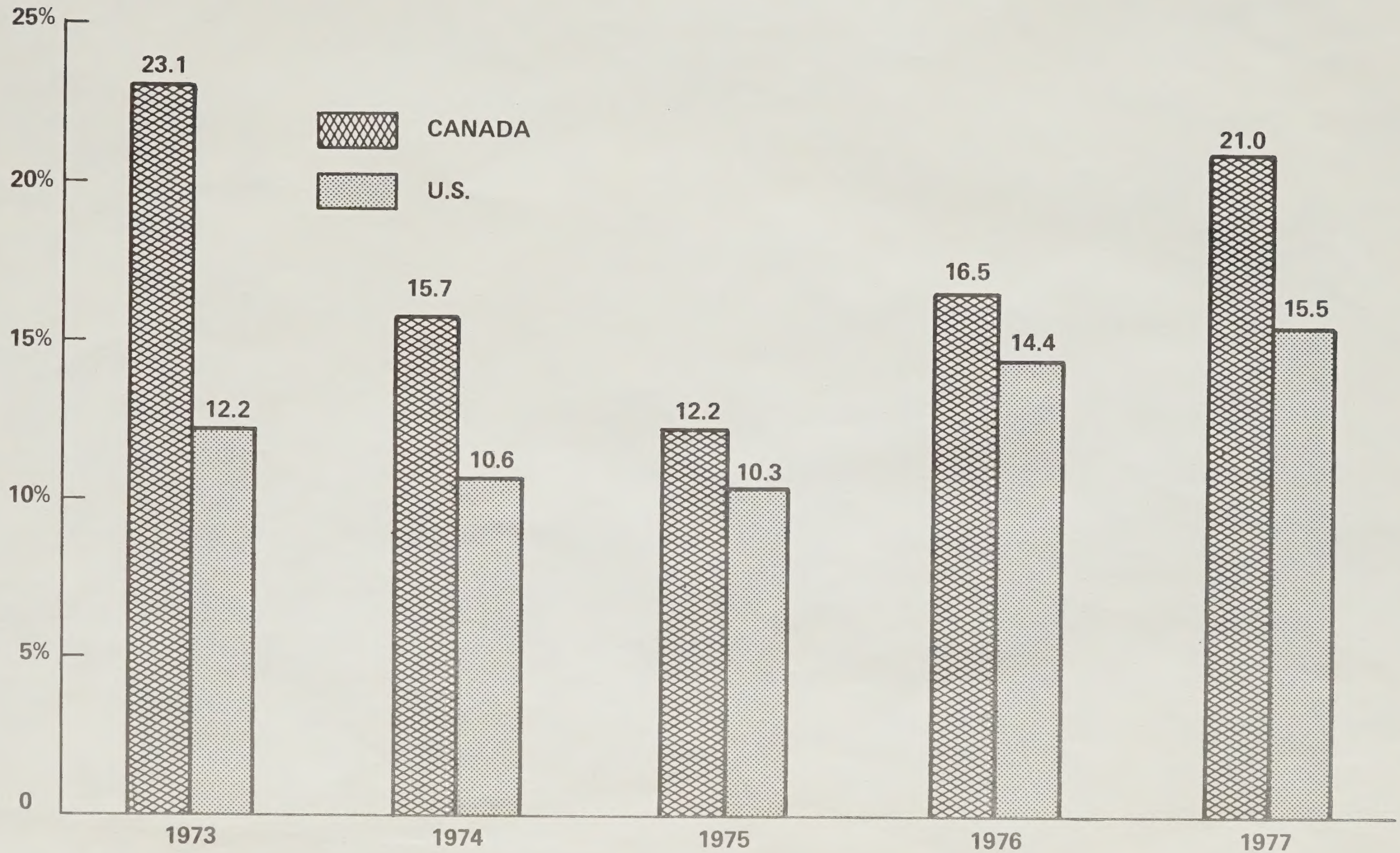
CHART 4
EMPLOYMENT IN THE CANADIAN AUTOMOTIVE INDUSTRY
1964-1977*
(in Thousands)



*1977 data is preliminary

Source: Statistics Canada, Catalogues 72-002 & 34-222, in Reisman, p. 106.

CHART 5
AFTER-TAX PROFITS OF THE MAJOR INDEPENDENT ORIGINAL-EQUIPMENT PARTS-MAKERS
1973-1977
(Percent of Net Worth)



Source: Computed from Financial Statements, S.E.C. 10K reports, in Reisman, p. 98